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IN THE

Supreme Court of the United States

October Term, 1975

No. 75-808

ANTHONY M. NATELLI,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF ON BEHALF OF PEAT, MARWICK, MITCHELL & CO., *AMICUS CURIAE*, IN SUPPORT OF THE PETITION FOR A WRIT OF *CERTIORARI*

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INDEX

PAGE

Interest of Peat, Marwick, Mitchell & Co. 1

Question Presented 2

Argument 2

Conclusion 10

TABLE OF AUTHORITIES

Cases:

Chris-Craft Industries, Inc. v. *Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) 6

Cohen v. *Franchard Corp.*, 478 F.2d 115 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973) 7

Ernst & Ernst v. *Hochfelder*, Docket No. 74-1042 (Oct. Term 1975) 4

Northway, Inc. v. *TSC Industries, Inc.*, Docket No. 74-1471 (Oct. Term 1975) 3

SEC v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) 7

United States v. *Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) 7, 8

Vohs v. *Dickson*, 495 F.2d 607 (5th Cir. 1974) 7

BLEED THROUGH

PAGE

Miscellaneous:

AICPA, *Statement on Auditing Standards No. 1* (1973) 6

AICPA, *Statements on Auditing Procedure No. 33* (1963) 6

A.L.I., *Model Penal Code* (Proposed Official Draft 1962) 5

APB, *Accounting Principles* (1968) 6

Securities Exchange Act of 1934
- Section 23(a), 15 U.S.C. § 78w(a) (1970) 5
- Section 23(a)(1), 15 U.S.C.A. § 78w(a)(1) (1975) 5
- Section 32(a), 15 U.S.C. § 78ff(a) (1970) 2, 5

S.E.C. Regulation S-X, Rule 3.02, 17 C.F.R. § 210.3-02 (1975) 6

Supreme Court Rules
- Rule 23.1(c) 2
- Rule 40.1(d)(1) 2
- Rule 42.1 2
- Rule 42.3 2

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This brief is submitted (with the consents of the petitioner and respondent which have been filed with the Clerk) on behalf of Peat, Marwick, Mitchell & Co. ("Peat, Marwick") in further support of the petition for *certiorari*.

Interest of Peat, Marwick, Mitchell & Co.

Until his conviction petitioner was a member of Peat, Marwick, and Peat, Marwick has always supported and now supports his defense. Beyond this particular interest, Peat, Marwick believes that there is another reason for the grant of the writ and that there is another controlling question of federal law presented which has not been but should be settled by this Court. They are of immense im-

portance both to Peat, Marwick, one of the largest partnerships of accountants in the United States, and to the profession of which its partners and professional staff are members. The reason and question are not expressly submitted in the petition. *See* Supreme Court Rule 42.1, .3.*

Question Presented

The following controlling question is presented and should be considered by the Court:

> In a criminal prosecution under Section 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78ff (a), alleging the knowing and willful misstatement of a material fact, must the jury be instructed to consider the defendant's culpability in respect of the materiality of the alleged misstatement both against an objective standard and as a question of whether the defendant, albeit objectively mistaken, honestly believed the fact to be immaterial?

ARGUMENT

The instructions to the jury by the district court and the decision by the court of appeals stand for the proposition that in a criminal prosecution under the securities laws for a knowing misstatement of a material fact the jury need not consider whether the defendant professional honestly believed the fact to be immaterial. The court of appeals concluded:

> "Materiality is an objective matter, not necessarily limited by the accountant's own uncontrolled subjec-

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* Since the second question presented by the Petition relates to the issue of knowledge, the question stated herein may be comprised therein. *See* Supreme Court Rules 23.1(e) and 40.1(d)(1).

tive estimate of materiality, see *United States* v. *Simon*, 425 F.2d 796, 806 (2 Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970)." (App. 15a to the Petition).*

The decision below poses a profoundly frightening prospect for accountants—and for lawyers or for that matter any other professional or layman who has responsibility for the contents of documents filed with the Securities and Exchange Commission. Such documents, which describe the affairs of complex business enterprises, are necessarily the products of judgments, most particularly judgments of materiality or immateriality, which in a practical sense are judgments of significance or insignificance and of inclusion or omission.

Precisely such a judgment of insignificance and of consequent omission is in issue here. The first specification of the indictment was directed to the fact that a footnote to NSMC's restated 1968 financial statements in its 1969 proxy statement did not separately set forth either the subsequent write-off of certain sales, costs and earnings

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* The court of appeals also said:

"In any event, the Court charged that the earnings figures would have to be 'known to be false in a material way'—a subjective test." (App. 15a to the Petition).

The pertinent portions of the district court's instructions concerning objective materiality and knowledge are set forth in the appendix hereto. We do not believe that any juror could have perceived the significance found by the court of appeals in the phrase it quoted. All that the jurors could have understood is that materiality is an objective question and that the question of knowledge relates to accuracy—not to materiality. In any case, the court of appeals established a rule of law for the future which definitively eliminates the issue of the honesty of the defendant professional's subjective judgment concerning materiality.

We also submit, as we did below, that the district court's charge concerning objective materiality, a question which is before this Court in *Northway, Inc.* v. *TSC Industries, Inc.*, No. 74-1471 (Oct. Term 1975), was itself erroneous: the district court instructed that materiality was established if the misstatement would "matter to" or "concern" a reasonable person (Appendix hereto, p. A2).

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reflected in the 1968 financial statements previously issued or the counterbalancing reversal of an unnecessary 1968 tax reserve, which together produced the insignificant net income effect of $21,000.

The practice of accountancy leading to the expression of opinions concerning the financial statements of business enterprises is quintessentially the making of judgments. The auditor's opinion speaks only to the fairness of presentation of the financial statements as a whole in accordance with generally accepted accounting principles. As the most obvious example of the judgmental quality of such opinions, the almost universally followed accrual method of accounting demands estimation and cannot produce certainty or precision.

We believe it may be assumed that the judgments made by accountants in the practice of their profession, although sometimes mistaken and sometimes the basis for civil liability, are, in all but the rarest cases, honestly made. But the decision below says that, in a criminal prosecution, the subjective honesty of a professional judgment is not pertinent if a lay jury finds that judgment objectively erroneous. *Mens rea* becomes immaterial to the determination of guilt or innocence.

In the context of the civil standard of liability which is before this Court in *Ernst & Ernst* v. *Hochfelder*, No. 74-1042 (Oct. Term 1975), *argued* December 3, 1975, the Securities and Exchange Commission submitted that accountants should not be held liable for mistaken judgments if honestly and conscientiously made. The Commission said:

> "Accountants, like other professional experts, are required to make difficult judgments reflecting the current status of the learning of their profession. They

should not be held to have performed their work negligently because their judgment, although honestly and conscientiously made, turns out on hindsight to have been mistaken." Brief for the Commission, *amicus curiae,* at 20n.14.

The necessary intendment of a criminal provision which is addressed to a "willful and knowing" misstatement of "material fact" is that the issue of knowledge relates both to the alleged misstatement and to the materiality of the misstatement. Section 32(a) makes no distinction whatsoever between the elements of misstatement and of materiality. *See* Section 2.02(4) of the A.L.I., *Model Penal Code* (Proposed Official Draft 1962), which provides:

> "When the law defining an offense prescribes the kind of culpability that is sufficient for the commission of an offense, without distinguishing among the material elements thereof, such provision shall apply to all the material elements of the offense, unless a contrary purpose plainly appears."

Moreover, the Act under which the indictment here was drawn expressly requires that the question of the defendant's own judgment of materiality be clearly put to the jury. Section 23(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78 w(a), provides that:

> "No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission . . . ." *

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* This provision was amended in 1975 to extend also to SEC orders. *See* Section 23(a)(1), 15 U.S.C.A. §78w(a)(1) (1975).

Rule 3.02 of the Commission's Regulation S-X, 17 C.F.R. § 210.3-02 (1975), the regulation which deals with financial statement presentation, provides that:

> "If the amount which would otherwise be required to be shown with respect to any item is not material, it need not be separately set forth." *

Thus, no liability, civil or criminal, can attach under the Securities Exchange Act of 1934 to a failure to state separately in a financial statement an amount which in good faith is believed to be immaterial.

In the context of civil litigation under the federal securities laws, whether the defendant was cognizant of the materiality of the matter allegedly misstated or omitted has been recognized as an element in determining liability. In *Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 369 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973), the Court of Appeals for the Second Circuit noted the "reasonable area of discretion in determining how far to explore the facts and in deciding what facts need be disclosed." In that connection the Second Circuit stated:

> "We do not hold that a corporation prima facie has acted unreasonably if the omission or misstatement is material. Corporate officials must be allowed considerable room for discretion; otherwise their normal functions as corporate officials will be inhibited. The to-

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* The controlling pronouncements of the accounting profession also advise accountants that ordinarily governing principles:

> "have application only to items material and significant in the relative circumstances. . . . [I]tems of little or no consequence may be dealt with as expediency may suggest."

APB, *Accounting Principles* § 510.09 (1968). *See also* AICPA, *Statements on Auditing Procedure No. 33* at 17 (1963); AICPA, *Statement on Auditing Standards No. 1* § 150.03-.04 at 6 (1973).

> tality of the facts and circumstances must be examined to determine whether the officials were reckless or grossly negligent." 480 F.2d at 369n.24.

The courts of appeals for other circuits have recognized this principle. In *SEC* v. *Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975), the Court of Appeals for the Sixth Circuit required the plaintiff to prove not only that the defendant knew or should have known of the allegedly omitted facts, but also, that the defendant

> "knew or should have known that the omitted information was significant . . . ." 493 F.2d at 1314.

Similarly, in *Vohs* v. *Dickson*, 495 F.2d 607 (5th Cir. 1974), the Court of Appeals for the Fifth Circuit, quoting from the Second Circuit's decision regarding the issue of scienter in *Cohen* v. *Franchard Corp.*, 478 F.2d 115, 123 (2d Cir.), *cert. denied*, 414 U.S. 857 (1973), held:

> "The standard for determining liability under Rule 10b-5 essentially is whether plaintiff has established that defendant . . . knew the material facts that were misstated or omitted *and* should have realized their significance . . . ." 495 F.2d at 622 (emphasis added).

The single citation by the court of appeals in support of its ruling was *United States* v. *Simon*, 425 F.2d 796, 806 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). We submit that *Simon* does not support, but rather directly contradicts, the court's ruling.

The page in *Simon* cited by the court related only to whether expert testimony of objective non-materiality must be given conclusive effect—a question which *Simon* answered in the negative. But the issue here is different. It is one of ***mens rea***, of culpability, of criminal knowledge—

not the preliminary question of whether a statement or omission, when judged objectively, is or is not material.*

The aspect of *Simon* which is indeed pertinent and contradictory of the court of appeal's reliance upon it, is the charge given by the district court in *Simon*. There, the jury was instructed to consider "whether [the defendant accountants] acted in good faith and on the mistaken assumption that netting might be a possibility" (*Simon* Tr. p. 4028). No such instruction was given here, and the decision of the court of appeals is that no such instruction need ever be given.

It was just such an instruction as that given in *Simon* which the facts of this case required.** Concededly, the footnote to NSMC's restated 1968 financial statements in its 1969 proxy statement did not separately set forth either that certain sales, costs and earnings reflected in the 1968 financial statements which NSMC had issued in 1968 had been later written off or that an unnecessary 1968 tax reserve had been reversed. The petitioner relied upon the judgment that explicit footnote disclosure of these two facts was of little significance to an investor's perception of what in September 1969 was a company radically different by reason of acquisitions and other changes from what it had been in November 1968 when NSMC's 1968 financial statements had first been issued.

The failure of the district court to instruct the jury to consider whether petitioner had, as charged in *Simon*, "acted in good faith and on the mistaken assumption that

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* We do not argue that a defendant professional's assertion that he believed a matter to be immaterial or insignificant is determinative of the issue of *mens rea*. We submit rather that the jury must be instructed to assess the honesty of his belief in deciding whether the defendant acted "willfully and knowingly".

** The reference by the court of appeals here to "netting" (App. 13a to Petition) should be compared with the charge to the jury in *Simon*.

netting might be a possibility", removed from the case the factors which petitioner contended permitted him to reach the judgment he did:

(1) The sales and earnings figures in the summary of earnings itself were accurate, and the reversal of the deferred tax liability was shown there as an extraordinary credit.

(2) An authoritative pronouncement of the accounting profession treated a footnote of this nature as a matter relating primarily to earnings trends, not sales.

(3) The impact of the write-offs on net earnings—the "bottom line"—was only $21,000, an inconsequential amount.

(4) The NSMC account executive, whose wrongdoing had apparently caused the problem of the written-off amounts, was no longer with NSMC. Adequate explanation of the write-offs seemed to require, however, pointed and possibly defamatory description of his conduct.

(5) Income from fixed-fee sales was, at that time, being accrued only if evidenced by a firm written commitment in a form agreed upon between NSMC and Peat, Marwick (in contrast to the 1968 oral commitments), and NSMC's experience with written commitments had been good.

(6) As a result of a number of acquisitions, NSMC's business had been substantially changed and enlarged since August 31, 1968 and thus the fixed-fee programs had become a much less significant element of NSMC's business.

(7) Petitioner's judgment was concurred in by a more senior Peat, Marwick partner who was responsible for reviewing the NSMC proxy statement.

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As the opinion of the court of appeals suggests (App. 14a to Petition), petitioner's judgment might have been made so as to conceal previous errors, or, as the record argues, petitioner's judgment might have been made because in all the circumstances he believed that specific disclosure in the footnote was of little significance. But, under the district court's instructions and the ruling of the court of appeals, the jury might have concluded that the latter was the case and still have found petitioner guilty.

CONCLUSION

It cannot be, we submit, that if a professional is mistaken in objective terms concerning a question of materiality, he is necessarily criminally mistaken.

The petition for a writ of *certiorari* should be granted for the reasons therein and herein stated and the question herein stated should also be considered by the Court.

Dated: New York, New York
February 5, 1976

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APPENDIX

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In the context of this case I instruct you that a defendant may be found to have acted wilfully and knowingly only if he knew that a portion of the financial statements recited in count 2, such as the footnote or a figure entry, was false and misleading. It is not enough, in other words, merely to establish that a given defendant acted negligently or through error or mistake. Although mistakes or negligence may give rise to civil suits, they do not constitute criminal conduct.

A finding of an intention to include false and misleading information of a material nature is required. Good faith, that is to say, an honest belief in the truth of the data set forth in the footnote and entries in the proxy statement, would constitute a complete defense here.

I point out that the prosecution, however, is not required to prove the making of the alleged false or misleading data or the defendants knowing, intentionally participations therein by direct proof, that is to say, by direct eyewitness evidence or the like. These elements of knowledge and intent, in other words, may be proved by circumstantial evidence, that is to say, by such inferences as may naturally and reasonably be drawn from all of the facts and circumstances as shown by the evidence in the case.

While I have stated that negligence or mistake does not constitute guilty knowledge or intent, nevertheless, ladies and gentlemen, you are entitled to consider in determining whether a defendant acted with such intent if he deliberately closed his eyes to the obvious or to the facts that certainly would be observed or ascertained in the course of his accounting work or whether he reck-

lessly stated as facts matters of which he knew he was ignorant.

If you find such reckless deliberate indifference to or disregard for truth or falsity on the part of a given defendant, the law entitles you to infer therefrom that that defendant wilfully and knowingly filed or caused to be filed false financial information of a material nature with the SEC.

But such an inference, of course, must depend upon the weight and credibility extended to the evidence of reckless and indifferent, conduct, if any.

I repeat: Ordinary or simple negligence or mistake alone would be insufficient to support a finding of guilty knowledge or wilfulness or intent. (Tr. 2363-65.)

* * *

Now, I have been talking about material facts. You heard material facts being discussed by lawyers and witnesses during the trial. I want to define here for you what the law means about material facts.

Let me approach it for you in this way. In deciding whether a fact is material, ladies and gentlemen of the jury, you are entitled to consider whether it was the kind of information that a financial statement ordinarily contains in order to fulfill its function of fairly presenting the financial picture of the company for which it is filed.

A material fact can be simply defined as one that would matter to a reasonable person in deciding whether or not to purchase NSMC's stock, for example. That is to say, a fact, the validity of which would concern a reasonable person in making his purchase or investment decision.

Obviously a balance sheet or income statement is not supposed to contain all the information a creditor or po-

tential investor or stockholder might need or want to know in order to make informed judgments. The function of the financial statement is simply to present a basic summary of the company's financial position and operations and earnings for the time period stated.

Now, in this connection I point out to you, and I should have made this point earlier, but I think you understand it, no one is contending, and it certainly is not the fact, that an outside auditing firm such as PMM has responsibility for the operations or management of a company such as NSMC. An auditor must ascertain that the financial statement in question, such as the figures or the footnote, fairly presents the results of the operations and the financial position of the company. Also, as stated heretofore, in effect, an auditor must honestly believe that that financial statement or statements are neither false nor misleading in respect to material facts.

Perhaps the critical issue in this case, therefore, can be summarized as follows: Were the quoted earnings figures and footnote set forth in Count 2 fairly set out? That is to say, did they fairly present the revenue and earnings picture for NSMC for the fiscal year 1968 and the first nine months unaudited of fiscal 1969?

If you determine that there is nothing materially false or misleading about this information as alleged in Count 2, that would end your inquiry and you would be obliged to acquit both defendants.

On the other hand, should you find that the quoted material is substantially inaccurate and misleading in whole or in part, then you would have to turn your attention to each of the defendants to consider what the evidence shows that he did or failed to do and to determine whether or not he participated in a scheme to knowingly and inten-

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tionally permit the submission of earnings figures known to be false in a material way to the SEC in the proxy statement.

If you find that such a scheme has been proved and if you determine that there is some evidence that a given defendant participated in this you still have to ascertain, of course, that the prosecution has established beyond a reasonable doubt that the defendant under consideration knowingly and wilfully either put or caused to be put false or misleading material facts into that proxy statement or knowingly and wilfully assisted in this conduct with a realization of what was going on and a desire to participate in this scheme.

If you find that a given defendant participated simply through carelessness or negligence, with a mistaken but nevertheless honest belief that his participation was correct, truthful and sufficient, then you should acquit that defendant.

If, on the other hand, you find that the defendant in question knew that the false or misleading data of a material kind were being placed in the proxy statement and then knowingly and intentionally did something to assist in this course of action you should find that defendant guilty. (Tr. 2368-71.)

• • •

You also asked me to talk again about knowingly and wilfully, what the law means by those words or that phrase.

Of course, I talked a great deal about that in various portions of my charge or instructions. What I intend to do is read what I think you have in mind and then I will ask you again to make sure I have covered what it is that you wanted.

I am embarrassed to say that I rushed down without my glasses. If you will just be patient a minute, I will read I think a little bit better than I would without.

I think, however, I can begin, even though my law clerk is coming, I am sure. Let me repeat something. I will instruct you once again, as I did this morning, on what a material fact is conceived to be by the law.

Incidentally, you asked if it was possible that you get this in writing. Under our system that's not possible. I will be obliged to orally do it again.

Let me repeat what I said this morning. I said that in deciding whether a fact is material you are entitled to consider whether it is the kind of information that a financial statement ordinarily contains in order to fulfill its function of fairly presenting the financial information or data in regard to the company or corporation in question, in our case, of course, NSMC.

I also defined a material fact as follows:

A material fact can be simply defined as one that would matter to a reasonable person in deciding whether or not to purchase stock, such as shares of stock in NSMC, that is to say, a fact the validity of which would concern a reasonable person in making his purchase or investment decision about the company in question.

I went on to say that obviously a balance sheet or income statement or data is not supposed to contain all of the information a creditor or a potential investor or stockholder might want to know or see in order to make an informed judgment. The function of the financial statement or an income statement is simply to present a basic summary of the company's essential financial position and its operations and earnings for the time or period stated or in question. (Tr. 2396-97.)

• • •

Now, is there anything further that you would like repeated for you?

Juror No. 1: Wilful and knowingly.

The Court: All right. Very good.

I repeat what I said in substance this morning. In the context of this case, ladies and gentlemen, a defendant may be found to have acted wilfully and knowingly only if he knew that a portion of the financial statement, such as the footnote or the financial data entries there that are alleged in count 2, was false and misleading.

It is not enough to prove, in other words, that he was acting knowingly and wilfully if all the evidence establishes is that a defendant under question acted negligently or carelessly. I pointed out that although mistakes or negligence might give rise to a civil lawsuit, they do not constitute a sufficient basis for finding criminal or culpable conduct.

A finding of an intention to include false or misleading information of material nature is required here in order to find that a defendant acted wilfully and knowingly.

Good faith, that is to say, an honest belief in the trust of the data set forth in the footnote or the other entries which are alleged in count 2, would not be proof of any knowing and wilful intention to do something misleading in the way of setting up entries or footnotes in these financial statements and thus support a criminal conviction.

Now, it is true, ladies and gentlemen, that in a great many other portions of my charge I was in part talking about knowing and wilfully. But that is the sum and substance of it as I stated this morning. But again, I ask you, is there anyone or more of you who would like anything more either on this subject or on some other subject in this area, generally speaking?

Does that seem to be about it?

All right. Very good. You may retire once again and take up your deliberations. (Tr. 2400-01.)

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Juror No. 1: Would you be kind enough and would it be in order to ask you to once again explain the term "knowing."

The Court: It certainly is very much in order and I would be more than happy to do that.

In the context of this case, ladies and gentlemen, a defendant may be found to have acted wilfully and knowingly only if he knew that a portion of the financial statement, such as a footnote or some other entry, was false and misleading. It is not enough merely to establish that a given defendant acted negligently or through error or mistake.

A finding of an intention to include false or misleading information of a material nature is required. Good faith, that is to say, an honest belief in the truth of the data set forth in the relevant footnote and entries in the proxy statement, would constitute a complete defense here.

In this connection, I point out to you that the prosecution is not required to prove the making of the alleged false or misleading statements or the defendants knowing and intentional participation therein by direct proof, that is to say, by direct eyewitness evidence or the like.

Such elements obviously may be proved by circumstantial evidence, by such inferences, in other words, as may naturally and reasonably be drawn from all of the facts and circumstances introduced into evidence.

While I have stated that negligence or mistake does not constitute guilty knowledge or intent, nonetheless, you are entitled to consider in determining whether a defendant acted with intent or knowingly if he deliberately closed his

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eyes to the obvious or to facts that certainly would be observed or ascertained in the course of his accounting work or whether he recklessly stated as facts matters of which he knew full well he was ignorant.

If you find such reckless deliberate indifference to or disregard for truth or falsity on the part of a defendant, the law entitles you to infer therefrom that that defendant wilfully and knowingly filed or caused to be filed false financial information with the SEC. But such an inference, of course, must depend upon the weight and credibility extended to the evidence of recklessness and indifference.

As stated, ordinary or simple negligence alone would be insufficient to support a finding of guilty knowledge or wilfulness. (Tr. 2426-27.)

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